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Client Alert

Senator Hillary Clinton Proposes New Rules on Executive Compensation

S. 2866 – Corporate Executive Compensation Accountability and Transparency Act

On April 15th Senator Harry Reid, acting on behalf of Senator Hillary Clinton, introduced the Corporate Executive Compensation Accountability and Transparency Act[1], which was referred to the Senate Committee on Finance. This bill proposes some major changes to the rules governing executive compensation.

Nonqualified Deferred Compensation

The bill would amend Section 409A of the Internal Revenue Code of 1986, as amended (Code), to place an ***annual limit of $1 million on nonqualified deferrals of compensation, including earnings*** on previously deferred compensation. Generally, if an amount is treated as "deferred compensation" for purposes of Code Section 409A, this bill's $1 million limit would apply. In applying the $1 million limit, the bill would aggregate all nonqualified deferred compensation accounts for an individual maintained by all employers. The bill would apply this provision to all taxable years beginning after December 31, 2008, but would only apply to amounts deferred (and earnings on such amounts) after that date.

Comment: *This provision could cause companies to end up with three separate deferral accounts for executives: a pre-409A deferral account, a pre-$1 million limit deferral account, and a post-$1 million limit deferral account.*

Shareholder Vote on Executive Compensation and Parachutes

After January 1, 2009, the bill would ***require shareholders to vote on executive compensation programs and levels disclosed*** in public company proxies. Additionally, shareholders would get to vote on any ***golden parachutes*** or other benefits given to executives upon a merger or acquisition. In both cases the votes would be ***non-binding***.

Senator Barak Obama introduced a bill that contained similar provisions for a shareholder vote on executive compensation disclosures contained in public company proxies as well as on golden parachutes[2].

Comment: *This provision would require public companies to offer shareholders an opportunity to vote on their executive compensation and golden parachutes after January 1, 2009. Companies may want to review the current status of "Say on Pay" proposals and look at the experience of the*

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[1] Text of the bill can be found at:
http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_bills&docid=f:s2866is.txt.pdf

[2] S. 1181, introduced April 20, 2007 and referred to the Senate Committee on Banking, Housing, and Urban Affairs. Text of the bill can be found at:
http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_bills&docid=f:s1181is.txt.pdf

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handful of companies that included such proposals in their proxies this proxy season so they can respond if this provision is enacted. Aflac received 93% support on its "Say on Pay" proposal, which was voted on by its shareholders at its May 5, 2008 annual shareholders meeting.

Disclosure of Compensation Consultant Activities and Independence

The bill would require the U.S. Securities and Exchange Commission (SEC) to issue regulations within 120 days after enactment that clarify and ***strengthen disclosure requirements*** pertaining to ***consultants or advisors to Compensation Committees***. The bill specifies that:

- ***Compensation consultants*** will be ***prohibited from providing any other work or service*** on behalf of the company (other than as advisor to the compensation committee) that presents a ***conflict of interest*** or ***otherwise compromises the independence of the consultant***;
- Companies must ***certify whether a compensation consultant*** that performed any work, research, or preparation, or otherwise had reasonable involvement in a compensation recommendation, ***is independent***; and
- The standards used by the SEC to determine independence of compensation consultants are to be clarified, and and are to include the following limitations:
    - A compensation consultant who at any time in the ***previous 18 months*** prior to the compensation recommendation of such consultant to a company had ***noncompensation consulting related business***, or otherwise had a ***noncompensation consultation related financial relationship*** with that company, shall not be considered independent; and
    - A ***compensation consultant*** that ***has or previously had any financial or professional relationship*** with a company, the board of directors of such company, or any senior executive officers of such company, that would ***reasonably be construed as presenting a conflict of interest*** in the compensation consultation recommendation of that consultant ***shall not be considered independent.***

Comment: *There is growing concern about conflicted Compensation Committee advisors, as evidenced by recent hearings conducted by the the House Committee on Oversight and Government Reform (Senator Henry Waxman, Chairman). This provision represents an attempt to legislate assurance of advisory independence. It would require public company Compensation Committees to engage independent compensation consultants to assist with compensation recommendations. Barring a delay in the effective date, the provision likely would apply during the calendar year (and not at the start of a company's fiscal year), which would further complicate a company's disclosures and might cause it to switch consultants midstream during the year. Any such midstream change could complicate proxy disclosures related to executive compensation actions during the year. The timing of the switch is further complicated by the stipulation that a consultant who performed any non-compensation services within the 18 prior months will not be considered independent. If the rule were to be effective January 1, 2009 (as currently proposed), current consultant relationships would be implicated.*

The Sarbanes-Oxley Act's Clawback Provision Amended

The bill would increase the period of the Sarbanes-Oxley Act's clawback provision from 12 months to ***36 months***. The bill would also require the SEC to develop rules for the effective application of the clawback provision. At minimum, the rules would include the following:

- The term ***"misconduct"*** includes misconduct that results from specific illicit actions of a senior executive or officer, including the CEO and CFO, of a company, or knowledge of illicit actions, accompanied by willful inaction to address such illicit actions, or the willful concealment by such executive or officer, of illicit actions.
- The term ***"illicit actions"*** includes any of the following actions:
    - Backdating stock options to conceal liabilities, losses, or any other negative financial information from shareholders and investors.

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- Accounting irregularities designed to conceal losses, liabilities, or other negative financial information from shareholders, boards of directors, or government regulators, that are required to be disclosed under the securities rules.
- Accounting irregularities designed to artificially achieve profit or other financial targets that would not have reasonably been met under generally accepted accounting principles and industry standards, or through compliance with federal securities and tax rules.
- Willfully circumventing the reporting, independence, due diligence, disclosure or fiduciary requirements and obligations under the federal securities laws in order to mislead, deceive, or withhold information that is required to be given to shareholders, boards of directors, and federal and state regulatory authorities.
- Any conduct that violates, or is in conflict with, the legal and fiduciary responsibilities of the senior executive or officer to the shareholders and board of directors of such executive or officer.

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The bill also gives the SEC the power to exempt any person from the Sarbanes-Oxley Act's clawback provision. However, if any exemption is granted, the SEC must issue a public statement explaining the rationale for granting such exemption and must notify the appropriate Congressional committees concerning the exemption.

Comment: *This provision would extend the clawback period quite significantly (triple the current period) and require the SEC to adopt rules concerning how the clawback provision works. To date, there has not been much guidance on the clawback provision under the Sarbanes-Oxley Act, although a number of companies have embedded the requirements in their compensation plans. Companies should review their compensation plans to determine if any action would be necessary if this provision is enacted.*

Federal Contractors Disclosure of Executive Compensation

The bill would also add requirements regarding the disclosure of executive compensation by certain federal contractors. Specifically, the bill would require that public companies that enter into certain contracts with federal executive agencies provide the contracting official with an ***accounting of the compensation structures for the CEO, CFO, five most highly compensated officers, and each member of the board of directors***, along with ***annual updates*** of such information thereafter. Also, public federal contractors must ***provide a compensation discussion and analysis that justifies the compensation structures for such individuals*** within 90 days after entering into a federal contract to the contracting official.

Comment: *This provision would require public federal contractors to justify their pay for their CEO, CFO, top 5 executives and directors. One would hope that disclosures provided under the securities laws would suffice, but this provision could require disclosures that extend beyond existing securities law requirements. The potential administrative requirements could be burdensome; federal contractors will have to wait and see how this provision might be applied.*

Conclusion

Executive compensation continues to be an area of emphasis for proposed legislation. The two Democratic presidential candidates have shown interest in addressing executive compensation. History has shown that Presidential positions with respect to executive compensation can affect legislation (former President Clinton actively promoted legislation that limited the deduction companies could take for compensation paid to their executives; that legislation became Internal Revenue Code Section 162(m)). Consequently, companies should monitor the status and potential impact of the proposed legislation on their executive compensation practices and procedures. To the extent enactment appears likely, companies should consider the substance and timing of their response(s) to facilitate their compliance with the new rules. Given the proposed January 1, 2009 effective date of the rules, companies should consider advance planning in the near-term.

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